

➤ Notes on the Week Ahead

Five Scenarios for the Federal Debt

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David Kelly
Chief Global Strategist

The Financial Accounts of the United States is a quarterly Federal Reserve publication containing a great many large numbers but very little commentary, presumably because the authors feel the numbers speak for themselves. And the numbers do speak rather loudly.

The latest edition, published in March, provides among other things, a snapshot of the liabilities of American households at the end of 2025. At that time, total household debt, including mortgages, credit card debt, student loans, auto loans and all other personal debt, was almost exactly \$20 trillion, or \$58,300 per person. However, in addition, Americans, by virtue of being citizens, indirectly owed \$30.9 trillion, or \$90,192 per person in federal government debt.

It should quickly be noted that total household assets, at over \$195 trillion, far exceed household liabilities. However, neither assets nor debt are spread evenly and many Americans lose sleep over their personal indebtedness.

The federal debt, however, induces no similar insomnia, for the obvious reason that, while people can calculate their own assets and liabilities, they have no way of estimating how much of the federal debt they will ultimately be responsible for.

Still it is an important issue, with federal debt rising from a low of 31% of GDP in the second quarter of 2001 to 101% of GDP by the first quarter of 2026. This number will almost certainly rise further in the years ahead, but how fast it does so and any attempts to slow its increase could have significant impacts on the economy and investing. This being the case, it is worth tracing out alternative scenarios for the path of federal debt and what they imply for the investment outlook. In particular, we consider:

1. Steadily rising debt-to-GDP with rising borrowing costs
2. Slowly rising debt-to-GDP with little market reaction
3. A fiscal crisis
4. Slower growth in federal debt via spending cuts, and,
5. Slower growth in federal debt via higher taxes

The Current State of the Federal Finances

Before digging too deeply into these scenarios, let's review where the federal finances are today.

expire, on schedule, at the end of 2028. If, as is likely, they are extended, this would further add to future deficits. Finally, April data on the tax filing season allows us to estimate the impact of OBBBA on the budget a little more clearly, while the war with Iran will obviously add something to defense spending.

The federal fiscal year runs from October 1st of the prior calendar year to September 30th of the current one and so, there are today, just over four months left in fiscal 2026. It now appears that the fiscal 2026 deficit will come in at roughly \$1.890 trillion or 5.9% of GDP, up from \$1.775 trillion or 5.8% of GDP in fiscal 2025. Federal debt in the hands of the public should rise to \$32.2 trillion or 100.4% of GDP by the end of this fiscal year, up from \$30.3 trillion or 99.7% of GDP at the end of fiscal 2025.

Taking a closer look at this year's budget, the \$1.890 trillion deficit is the difference between \$7.385 trillion in spending and \$5.495 trillion in revenues.

The spending total includes \$1.037 trillion in interest payments along with, (using February CBO numbers), roughly \$1.666 trillion in social security payments, \$1.908 trillion in major medical spending programs and \$885 billion in defense spending. All other spending by the federal government is expected to total \$1.951 trillion.

On the revenue side, the vast majority of financing is expected to come from \$4.650 trillion in personal income and payroll taxes, supplemented by roughly \$390 billion in corporate income taxes, \$255 billion in net tariff revenue and \$200 billion in other taxes.

It's important to appreciate the relative magnitude of these numbers when considering how spending cuts or revenue increases could be used to narrow the deficit going forward.

A Baseline Scenario – Steadily Rising Debt with Rising Borrowing Costs

Starting with a baseline scenario, in its February 2026 budget outlook, the CBO projected that the federal debt would rise from 100.6% of GDP at the end of fiscal 2026 to 120.4% at the end of fiscal 2036. However, this forecast assumed that tariff revenue would average \$403 billion per year over the forecast horizon and that the new tax breaks introduced as part of the OBBBA would expire on schedule. If, instead, we assume that tariff revenue is \$150 billion a year lower than was projected then and that these new tax breaks effectively become permanent², the debt to GDP ratio would rise to 127.7% of GDP by 2036.

Moreover, if anything, this is probably on the optimistic side. It makes no allowance for further tax breaks or additional defense spending due to wars in the Middle East or elsewhere. In addition, the economic forecasts underlying the CBO's baseline projections look, if anything, somewhat optimistic. At first glance, the long-term view of a 1.8% growth rate in real GDP looks reasonable, as does the prospect of a 4.3% average unemployment rate and a 4.3% 10-year Treasury yield. However, it makes no provision for any recession or any surge in inflation. If, as seems more likely, the economy encounters bouts of both recession and inflation in the decade ahead, the debt-to-GDP ratio could well reach 130% by 2036.

Under this scenario, real long-term bond yields would likely rise from current levels. But by how much?

In a recent Dallas Fed paper³ the authors concluded that a 1 percentage point increase in the debt-to-GDP ratio raised the 5-year-ahead, 5-year Treasury rate by 3 basis points. Consequently, an increase in the debt/GDP ratio from 100% today to 130% by 2036, could boost the 5-year/5-year yield by 90 basis points.

Under certain assumptions, this would have the same impact on a 10-year U.S. Treasury bond, boosting the yield from 4.56% as of Friday to 5.46% a decade from now. This steady increase, with an average yield of roughly 5% and an average duration of close to 8, would imply a roughly 70 basis point annual haircut to bond returns over the next decade - no reason to abandon bonds altogether but clearly limiting total returns and reducing the ability of bonds to offset any stock market selloffs along the way.

An Optimistic Scenario – A Slow Deterioration with Little Market Reaction

Of course, in an optimistic scenario, it is quite possible that the federal finances deteriorate at a slower pace and/or that the bond market shrugs it off.

First, real economic growth could be stronger than suggested by the CBO baseline, if AI provides a stronger-than-expected boost to productivity or

In addition, rising debt doesn't necessarily mean higher interest rates. In the middle of 2001, when the federal debt/GDP ratio was less than a third of its current level, the yield on a 10-year Treasury was 5.42% and the yield on a 10-year TIP was 3.50% , actually somewhat *higher* than today's values of 4.56% and 2.14% respectively. In the interim, increasing income inequality funneled money towards the stock and bond markets while foreign investors displayed a healthy appetite for U.S. bonds, pushing yields down.

This might well continue and, if it did, while economists would continue to decry the eventual impact of high deficits and rising debt, neither the bond market nor the stock market might pay any attention. In this scenario, while bonds would hold their own, global equities and, particularly U.S. equities could continue to shine.

A Pessimistic Scenario – The Potential for a Fiscal Crisis

A fiscal crisis is another possibility. This scenario would most likely unfold not due to trends in the economy and financial markets but rather from the behavior of the federal government itself.

One perennial threat is a failure to raise the debt ceiling. Last July, as part of the OBBBA, Congress increased the debt ceiling from \$36.1 trillion to \$41.1 trillion. This applies to a concept called "debt subject to limit" which includes the federal debt held by the public as well as money owed by the government to its own trust funds. As of May 21st, the debt subject to limit was more than \$2 trillion below this ceiling, not counting the roughly \$800 billion that the Treasury Department holds in its checking account at the Fed. Consequently, the debt limit won't need to be increased before the summer of 2027 at the earliest. However, at that time, as has often happened in recent years, one or other of the parties in Congress could threaten not to raise the debt ceiling. Markets have come to expect these threats and have generally ignored them. However, it should go without saying that, if the U.S. government ever did default on its debt, the immediate impact on Treasuries and global financial markets more generally could be catastrophic.

Another threat revolves around Fed independence. This administration, in particular, has been very aggressive in trying to pressure the Fed to lower interest rates, including attempts by the President to fire Governor Lisa Cook and a Justice Department investigation into the former Chairman of the Fed, Jerome Powell. The threat appears to have diminished, for now, with the Justice Department dropping its probe and Powell's decision to stay on as governor. It could be further reduced if the Supreme Court rules that the President doesn't have the right to fire Governor Cook. However, if the Supreme Court rules for the President, the threat of a Fed that is subservient to the White House will become very real again. This could precipitate a crisis in the Treasury market, since it could imply that, in future, the Fed could be coopted into financing federal spending plans and might be forced to abandon attempts to control inflation.

Or more broadly, U.S. politicians might judge that the public is quite content for the government to borrow unlimited quantities of funds to finance popular tax cuts or spending plans. It is worth noting that most of today's federal debt is the result of unfunded tax cuts, stimulus checks and wars rather than prolonged economic underperformance.

If, for any of these reasons, global investors completely lost confidence in U.S. Treasuries, then long-term interest rates would rise and the dollar would presumably decline. However, this could also result in a sharp fall in risk assets around the world which could, perversely, mean that some other assets would suffer greater setbacks than U.S. Treasuries.

Reining in the Federal Debt through Spending Cuts

It is also possible, although difficult, to imagine a scenario by which the U.S. government reduces the growth in the debt through spending cuts. This is where the actual current budget numbers become most relevant.

One possibility, (that should probably be ruled out), is trying to force the Fed to cut interest rates to reduce the over \$1 trillion being spent on interest payments. The problem with this is that to attempt this by lowering short rates, the Fed might convince investors that it is not serious about reducing inflation and this could increase long rates. Cutting social security benefits is presumably off the table. Slowing the growth of spending on Medicare and Medicaid is more possible. However, this runs into two strong headwinds of a demographic surge in the size of the elderly population and the proliferation of new but expensive drugs and treatments for serious illnesses. From a global perspective, it goes without saying that the fiscal situations of the United States, China, Russia and Europe would be vastly improved by a collective agreement to reduce defense spending. However, this would require a desire on all sides to use diplomacy rather than force to achieve national objectives, a desire that, sadly, is not very evident today.

employment since at least 1939. This suggests very little room for further cost savings here either.

If, despite all of this, a serious attempt was made to rein in federal deficits by reducing spending, the result would be positive for the bond market, although ambiguous for other markets, since the impact of the resulting economic drag on corporate profits could outweigh the benefits of lower interest rates.

Reining in the Federal Debt through Tax Increases

In theory, the federal debt could also be reined in by higher taxes. Some of the potential revenue-raisers are outlined in a CBO publication entitled *Options for Reducing the Deficit*, which was most recently published in December 2024⁴.

However, many of the options explored, such as increasing payroll taxes or general individual income tax rates are so unlikely to be enacted that they can safely be ignored. A slightly higher probability could be assigned to increases in corporate income taxes, personal taxes on upper income households, capital gains taxes or estate taxes. If these were enacted and were not fully offset by lower taxes on lower-income households or federal government spending, the result might be a slower rise in the debt-to-GDP ratio, likely with beneficial impacts for Treasuries. The implications for stocks and other financial assets, however, is ambiguous. Lower interest rates would be a positive. However, to the extent that higher taxes on investment income cut the total after-tax return on certain assets, prices of those assets could be negatively impacted.

Conclusion

In assigning probabilities to these scenarios, investors should probably focus on the process by which Americans elect Congress and the President, rather than over-analyzing either the economic landscape or the competence and public-spiritedness of elected officials.

A first-past-the-post, low-turnout primary system ensures that in many cases the public is left to choose between candidates that are far to the left and far to the right. The largely unfettered use of special interest and private money in elections leaves these representatives committed to maintaining tax breaks and spending programs rather than managing the federal finances. And achingly long election campaigns, where media coverage always concerns the race and never focuses on policies, leave voters bored and uninformed.

In this environment, to win election, candidates accuse their opponents of wanting to raise taxes or slash public services and, once in office, dealing with deficits always takes a back seat to protecting current spending programs and tax breaks and pursuing new ones.

Given this, we can be reasonably sure that no serious attempt will be made to reduce deficits through tax increases and spending cuts over the next decade. A fiscal crisis scenario is somewhat more likely. However, if, after the November elections, the U.S. returns to divided government, the threat to Fed independence will probably fall as will the prospect of further unfunded fiscal stimulus. So, most likely, the debt will continue to drift steadily higher – boosted by occasional bouts of government irresponsibility and national emergencies but held in check, to some extent, by better real GDP growth due to technological progress and renewed growth in the labor force.

If this transpires, then rising federal debt isn't a reason to abandon long-term investing. However, it is a reason to diversify into alternative assets, in addition to high-quality fixed income, to add stability to portfolios and to add international assets, since rising U.S. debt could eventually contribute to a falling U.S. dollar.

¹ See *The Budget and Economic Outlook: 2026 to 2036*, Congressional Budget Office, February 11th, 2026

² See *Effects on the Effects on Deficits and the Debt of Public Law 119-21 and of Making Certain Tax Policies in the Act Permanent*, CBO letter to Senator Jeff Merkley, August 4th, 2025

³ *Revisiting the Interest Rate Effects of Federal Debt*, Michael D Plante, Alexander W. Richter and Sarah Zubairy, Dallas Fed Working Paper 2513, April 2025 (Revised July 2025)

⁴ *Options for Reducing the Deficit: 2025 to 2034*, Congressional Budget Office, December 2024

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